REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

THE STATE'S ROLE IN THE REGULATION OF THE WESTERN COMMUNITY MONEYCENTER

P-525

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Thomas W. Hayes
Auditor General

February 21, 1986 P-525

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the State's role in the regulation of the Western Community MoneyCenter. We found that the Department of Corporations needs to develop a comprehensive examination and monitoring program for industrial loan companies that have not obtained insurance coverage from the Federal Deposit Insurance Corporation.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

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SUMMARY

The Department of Corporations (department) does not have adequate methods of detecting the conditions that led to the failure of the Western Community MoneyCenter (MoneyCenter). If the department does not implement appropriate controls, it is possible that the department will not detect similar problems in the other industrial loan companies it regulates.

The department did not adequately examine and monitor the financial condition of the MoneyCenter during the time that the MoneyCenter was rapidly expanding. Therefore, the department did not detect sooner the poor management practices at the MoneyCenter that resulted in major losses from delinquent loans. As a result of the failure of the MoneyCenter, the State is at risk to the extent that the MoneyCenter's assets are insufficient to repay the $63 million loan that the State guaranteed to pay off the MoneyCenter's thriftholders. The amount of the loss to the State as guarantor of the loan, if any, is not yet known because losses are still being recorded on the loans owed to the MoneyCenter.

The department's examination procedures did not address the quality of the loans that the MoneyCenter was making. We compared the department's procedures for examining industrial loan companies with those of the State Banking Department and the Federal Deposit Insurance Corporation (FDIC). In contrast to the department, the State Banking Department and the FDIC use a "risk-oriented" approach to evaluate the quality of a bank's assets; that is, they evaluate the loans and the corresponding financial risk that the bank assumes in granting the loans. The rapid growth that the MoneyCenter experienced between August 1981 and July 1983 would have triggered a special examination of loan quality by the FDIC.

In addition, the department did not examine and monitor the MoneyCenter frequently enough to detect problems. The department's policy is to conduct a quarterly examination within 60 to 90 days of a change in ownership. However, the department conducted its first quarterly examination 6 months after the change of ownership. Furthermore, the department's policy is to conduct a full regulatory examination once each year. However, the department did not conduct a full regulatory examination during 1982. The department began its first full regulatory examination in June 1983. In addition to examinations, the department monitors the operations of industrial loan companies by analyzing their periodic financial reports. However, the department failed to document its review of the MoneyCenter's reports for the 11 months between August 1982 and June 1983. During this period, the MoneyCenter's thrift obligations increased by almost 400 percent.

The department does not examine loan companies with a change in ownership and a troubled financial history as frequently as the State Banking Department and the FDIC examine banks in similar circumstances. The FDIC conducts an examination of banks that change ownership within 30 days. For banks with a troubled financial history, the State Banking Department and the FDIC alternate examinations every six months during the year following the initial examination performed by the FDIC.

Finally, the department did not use the authority it had to disapprove the MoneyCenter's request for additional branch offices. The department's examiners became aware of material weaknesses in the internal financial controls at the MoneyCenter during June and July 1983. Nevertheless, on August 22, 1983, the department approved the MoneyCenter's requests for four new branches despite evidence that the company's financial condition as represented by its financial statements could not be relied upon. One of these branches actually opened, and thriftholders associated with the new branch were needlessly placed at risk.

Regulations governing the State's industrial loan companies have changed since the failure of the MoneyCenter. Thrift Guaranty Corporation was the sole guarantor of thriftholders' accounts at the State's industrial loan companies. As a result of the Garn-St. Germain Act in 1982, the United States Congress authorized the FDIC to insure the thrift obligations of industrial loan companies. As of October 1, 1985, the FDIC insured thrift obligations of 23 of the 65 industrial loan companies in the State. These 23 industrial loan companies have 61 percent of the total outstanding thrift obligations. Another 16 companies had applications pending before the FDIC as of October 1, 1985. These 16 companies have another 20 percent of the total outstanding thrift obligations. Furthermore, Chapter 1349, Statutes of 1985, contains provisions to eliminate the Thrift Guaranty Corporation by 1990. Existing loan companies have until 1990 to qualify for either FDIC insurance or other insurance options or to give up their licenses. New industrial loan companies must obtain insurance either from the FDIC or from a similar federal organization as a provision of doing business in the State.

The department and the FDIC are developing a joint examination program for the companies insured by the FDIC. However, until the Thrift Guaranty Corporation is eliminated in 1990, the department needs to develop a comprehensive examination and monitoring program to ensure that those companies that cannot or will not obtain FDIC insurance are subject to the same level of supervision as the companies that have qualified for FDIC insurance.

INTRODUCTION

The Department of Corporations (department) is currently responsible for regulating 65 industrial loan companies in California with thrift obligations of approximately $2 billion. This responsibility includes reviewing applications for licenses to determine if the company has adequate financial and personnel resources; monitoring the company's financial condition and operating procedures to ensure that the company complies with the laws and is operating in a safe and sound manner; and enforcing the Industrial Loan Law. The provisions of this law are included in the California Financial Code. Title 10 of the California Administrative Code amplifies the code where more detail is required. While the law is generally explicit about such items as the amount of capital required of an industrial loan company and the amount of thrift obligations a company can accept, the law is silent with regard to the methods and the frequency with which the department determines if an industrial loan company is complying with the law. Therefore, the department's Financial Services Division establishes policies to examine and to monitor industrial loan companies.

The department conducts examinations of established industrial loan companies to determine if the company is complying with the laws and regulations and with the department's policies. The department also monitors the financial condition of the industrial loan companies it regulates by analyzing periodic financial reports prepared by the

industrial loan companies' management and by analyzing annual financial audit reports prepared by the industrial loan companies' independent auditors. If an industrial loan company's financial condition deteriorates or an industrial loan company does not comply with the laws and regulations, the Commissioner of Corporations (commissioner) has a variety of options available. The commissioner has the authority to determine whether an industrial loan company is engaging in unsafe business practices or in specific violations of the law and to determine what action is appropriate to correct these practices or violations. The commissioner may issue administrative orders to stop unsafe business practices or violations of the law. The commissioner may make agreements with an industrial loan company's management to take specific actions, or the commissioner may seek court injunctions. There are no provisions in the law to assess monetary penalties against industrial loan companies that fail to comply with the law.

Before January 1, 1984, the law required industrial loan companies to obtain membership in the Thrift Guaranty Corporation (corporation). The Legislature created the corporation under the authority of the Nonprofit Mutual Benefit Corporation Law to act as a trust fund for the State's industrial loan companies and to guarantee their thriftholders' accounts up to $50,000. The corporation is a private, nonprofit corporation governed by a board of directors elected from its members. Member industrial loan companies pay an initial fee of $100,000 plus annual assessments of fifteen-hundredths of one percent of their thrift obligations to maintain the fund balance at

one and one-half percent of the total thrift obligations of its members. Before July 1, 1985, the corporation had no authority to reject an industrial loan company that applied for membership. It also had no permanent offices or paid staff.

An industrial loan company may generate funds by selling investment certificates to the public. Investment certificates, also known as thrift certificates, may be in the form of passbook accounts to which thriftholders make periodic investments or in the form of term certificates that are purchased in a single installment and that mature at the end of a specific period. Thrift certificates represent obligations of the company to be repaid to the thriftholders.

To generate the funds to earn a profit and to pay the interest on thriftholders' accounts, industrial loan companies loan their funds to companies for commercial purposes and to individuals for consumer purposes for items such as business equipment, automobiles, and real estate. When the commissioner took possession of the MoneyCenter, unaudited financial records showed that for the month ended February 29, 1984, the MoneyCenter owed its thriftholders $106 million while those who had borrowed money from the MoneyCenter owed it $95 million. Of the $95 million owed to the MoneyCenter, over $24 million was past due. In addition, the MoneyCenter had approximately $13 million in loan losses already recorded. However, because of the extent of the deficiencies in the accounting system and because loan losses are still being recorded, the MoneyCenter's

financial records cannot be relied upon to accurately reflect the economic reality of the MoneyCenter's financial condition. Consequently, the department is still determining the extent of the MoneyCenter's losses. (The Appendix presents a summary of the events at the MoneyCenter from its purchase in August 1981 as Charter Thrift and Loan until April 1984 when the commissioner took possession of the MoneyCenter.)

Recent Changes in the Regulation of Industrial Loan Companies

Since January 1, 1984, regulatory changes have occurred that provide better control over the industry for those industrial loan companies insured by the Federal Deposit Insurance Corporation (FDIC). Industrial loan companies that can meet the requirements for federal coverage may now seek insurance from the FDIC to insure their members' thrift obligations up to $100,000. While there are no initial fees, covered industrial loan companies pay at the rate of one-twelfth of one percent of a covered company's average thrift obligations less certain exclusions and deductions.

The United States Congress created the FDIC in 1933 as a federal bank regulatory agency. In 1982, the Congress passed the Garn-St. Germain Depository Institutions Act, which allows industrial loan companies to seek insurance for their thriftholders' accounts from the FDIC. In addition to providing insurance, the FDIC examines and supervises those banks and industrial loan companies under its purview,

approves or denies applications for structural or corporate changes in banks and industrial loan companies, and rules on applications for insurance.

If an industrial loan company fails and is not sold or merged with another company, Thrift Guaranty Corporation's (corporation) "guarantee" differs from FDIC insurance primarily in the amount of guarantee and in the length of time in which a thriftholder can be reimbursed for his or her funds. The corporation guarantees each thriftholder's account for a maximum of $50,000; the FDIC insures each thriftholder's account for a maximum of $100,000. Furthermore, the FDIC is obligated to reimburse a thriftholder once it determines that the thriftholder's claim is a valid claim. However, to obtain reimbursement from the corporation, the commissioner must first estimate the proceeds of selling the assets of the failed company to pay the thriftholders and other creditors what the company owes. The commissioner then directs the corporation to pay up to $50,000 to make up any deficiency from the sale of the assets. Rather than delay payments to the MoneyCenter's thriftholders to allow for these procedures, the State guaranteed a $63 million loan from a private bank to the corporation so that it could reimburse the MoneyCenter's thriftholders sooner.

Chapter 1349, Statutes of 1985, effective October 1, 1985, introduced changes affecting guarantees for thriftholders of industrial loan companies. Existing industrial loan companies have until

July 1, 1990, when the corporation will cease to exist, to qualify for and to obtain insurance from either the FDIC or from other specified sources. New industrial loan companies, as a condition of doing business, must now obtain insurance for their thriftholders' accounts from either the FDIC or from a similar federal organization. Those industrial loan companies electing to change to FDIC coverage are subject to regulation by the FDIC.

As of October 1, 1985, the FDIC has approved 23 applications for FDIC coverage from the 65 existing industrial loan companies in California. Based on June 30, 1985, outstanding thrift obligations, these 23 companies represent 61 percent of the thrift obligations in the State's industrial loan companies. Another 16 companies, representing 20 percent of the outstanding thrift obligations, have applications pending with the FDIC. Five companies' applications were either withdrawn by the industrial loan companies or rejected by the FDIC, and 15 companies with outstanding thrift obligations have not yet applied for coverage. These 20 companies that have not applied or have been rejected represent 19 percent of the State's industrial loan companies' outstanding thrift obligations. Six of the State's 65 industrial loan companies did not have any outstanding thrift obligations.

SCOPE AND METHODOLOGY

The purpose of this audit was to determine the State's role in the regulation of the MoneyCenter. In the course of our review, we examined the regulatory functions of the department and the corporation over the State's industrial loan companies. We also compared the department's regulatory authority and the corporation's guarantee practices with other regulators of the State's financial institutions and their federal insurers. These included the State Banking Department (regulator) and the FDIC (insurer) as well as the state Department of Savings and Loan (regulator), the Federal Home Loan Bank (regulator), and the Federal Savings and Loan Insurance Corporation (insurer). Because the FDIC is currently insuring industrial loan companies, our comparison with other regulatory agencies focuses on the regulatory practices of the State Banking Department and the FDIC.

During our review, we conducted interviews and analyzed laws, codes, regulations, and the department's policies. We also reviewed documents and correspondence in the department's business operation files.

AUDIT RESULTS

I

THE DEPARTMENT OF CORPORATIONS HAS INADEQUATE METHODS OF DETECTING UNSAFE CONDITIONS IN THE INDUSTRIAL LOAN COMPANIES IT REGULATES

The Department of Corporations (department) does not have adequate methods of detecting the management problems that led to the failure of the Western Community MoneyCenter (MoneyCenter). From August 1981 through July 1983, the MoneyCenter expanded rapidly; its thrift obligations grew from $5 million to $125 million. However, during this period of rapid expansion, the department did not adequately examine and monitor the financial condition of the MoneyCenter and therefore did not detect the poor management practices that resulted in major loan losses to the MoneyCenter. The department is still determining the extent of the MoneyCenter's losses. If the department does not implement procedures to detect management problems, other industrial loan companies could develop similar problems that could go undetected by the department.

The department failed to detect major problems at the MoneyCenter sooner because it did not conduct periodic examinations as frequently as prescribed by its policy. However, even if the department had monitored the MoneyCenter more frequently, its examination procedures were not comprehensive enough to adequately evaluate the quality of the loans the MoneyCenter made. Furthermore,

the department did not adequately monitor the MoneyCenter during the 11-month period in which its thrift obligations increased almost 400 percent. The department also did not verify the financial data that supported the MoneyCenter's requests for expansion. Discrepancies in the financial data should have triggered further investigation by the department.

Growth of the MoneyCenter

The MoneyCenter, originally named Charter Thrift and Loan, began operations in August 1981 with approximately $5 million in thrift obligations. By February 1982, after six months under new management, the MoneyCenter's thrift obligations had increased from $5 million to $11 million. Loan delinquencies also improved, down from almost 13 percent to 5 percent of the total amount the company had loaned.

The MoneyCenter grew rapidly between February 1982 and June 1983. By June 1983, the department had allowed the MoneyCenter to accept thrift obligations totalling $109 million, an increase of over 700 percent, and to open eight new branches. During this period, the MoneyCenter also increased the total amount of the loans it granted from $16.6 million to $99 million. The MoneyCenter's growth peaked in July 1983, at $125 million in thrift obligations. During this period of extremely fast growth, the department allowed the MoneyCenter to expand unchecked; the department did not employ the necessary methods to detect the management problems that led to the failure of the MoneyCenter.

The Department's Examination Procedures Are Inadequate To Detect Weaknesses in an Industrial Loan Company's Loan Portfolio

The department's examination procedures do not address the quality of a company's loans. To determine if the industrial loan company is complying with the applicable state laws and regulations, department examiners review an industrial loan company's loan portfolio, which may include real estate loans, contracts for leasing business equipment and automobiles, and loans for consumer purposes. For example, in February 1982, the examiners reviewed the MoneyCenter's loan portfolio to determine if it was properly documenting its loan transactions. The examiners reviewed loans to ensure that the loan files included the required insurance policies and that the title to property that secured loans was properly conveyed to the MoneyCenter. Examiners also determined if the MoneyCenter made its loans within the limits specified by the law. The examiners did not, however, examine the loan portfolio to determine if the company was using sound business practices in making loans.

One of the methods to evaluate the quality of loans an industrial loan company makes is to review its loan files to determine if the company has verified the ability of the borrower to repay the loan and to determine if the amount of money loaned on a property is supported by a realistic, independent appraisal of the property's market value. Although the department requires the examiners to determine the total amount of loans that are actually delinquent,

examiners are not required to investigate further to evaluate the risk the industrial loan company has assumed in granting its loans. The department has identified this lack of evaluation as a problem and is developing an examination program to increase its supervision over the industrial loan companies it regulates.

The MoneyCenter's lending practices led to poor quality loans and resulted in substantial loan losses. During 1982, the MoneyCenter sold to other financial institutions approximately $17 million in second mortgage real estate loans it had granted.* The MoneyCenter earned approximately $1 million in fees on these transactions. By the end of 1983, a corporations examiner from the department said that the total value of loans sold to other institutions had increased to approximately $31 million. The MoneyCenter eventually had to repurchase approximately $12 million to $13 million of these loans that it had sold "with recourse" because the borrowers failed to repay their loans within the terms of the loan. When loans are sold "with recourse," the purchasing institution receives a guarantee from the selling institution that the borrower will repay the loan according to the terms of the loan agreement. If the borrower fails to repay the loan, the purchasing institution can return the loan to the selling institution for another one of equal value or for cash.

*Our reference to these transactions as "sales" of loans is based on certain letters and agreements between the MoneyCenter and other parties and a report prepared by the MoneyCenter's independent accountant. We did not determine whether these transactions actually constituted "sales" in a legal sense. The legal substance and effect of these transactions is now disputed in pending litigation.

In November 1983, a special examination committee from the Thrift Guarantee Corporation (corporation) made up of industry managers and specialists examined the MoneyCenter's loan files and reported that the MoneyCenter granted loans to individuals who lacked a demonstrated capability to repay a loan. According to the committee, the MoneyCenter also granted loans to individuals and commercial borrowers that exceeded the amounts that should have been prudently loaned.

The corporation's special examination committee reviewed the MoneyCenter's equipment leases, auto contracts, commercial loans, and real estate loans. In its review of leases and automobile contracts, the corporation found that the MoneyCenter did not independently verify the borrower's ability to make the lease payments, and there were no established policies for approving credit applications. Further, automobile values were inflated in relationship to the amount that was financed. In the MoneyCenter's $10 million commercial loan portfolio, the special examination committee concluded that there was no evidence that the MoneyCenter's management understood and used elementary procedures and requirements to establish and to monitor new loans. Specifically, the MoneyCenter did not conduct any audits of prospective borrowers, nor did it conduct any independent verifications after it granted the loans. Finally, the special examination committee found that, of the $14 million in loans it reviewed in the real estate portfolio, the MoneyCenter also loaned more than another lender would have loaned under similar circumstances. By the MoneyCenter's own projections at the time of the special examination committee's review

in November 1983, the MoneyCenter expected to repossess 102 properties in the four-month period from October 1983 through January 1984.

Rather than take possession of the MoneyCenter after the special examination committee's review, the Commissioner of Corporations (commissioner) elected to attempt to find a buyer for the MoneyCenter while it continued to operate under the limitations imposed by the department. On November 17, 1983, the commissioner informed the management and the directors of the MoneyCenter that, due to the extent of its problems, the MoneyCenter had to be sold. Further, current management was to be replaced and the sale was to be completed by no later than February 17, 1984. Thereafter, the MoneyCenter, the Thrift Guaranty Corporation, and the department attempted to negotiate a sale of the MoneyCenter. Western Community Financial Group, the MoneyCenter's parent company, found a buyer for the MoneyCenter and its affiliated savings and loan company. However, the Federal Home Loan Bank Board disapproved the sale on April 4, 1984. A second buyer decided not to buy the MoneyCenter on April 19, 1984. On April 20, 1984, the department took possession of the MoneyCenter.

To evaluate the department's method of examining the industrial loan companies it regulates, we reviewed the procedures other regulators use to examine a financial institution's loan portfolio. Both the Federal Deposit Insurance Corporation (FDIC) and the State Banking Department have "risk-oriented" programs to supervise banks. That is, the FDIC evaluates a bank's lending practices to

determine the risk to the bank as a lender. According to the review examiner at the FDIC, rapid growth in a bank's assets or a troubled financial history would trigger a review of its loan portfolio. When the FDIC reviews a loan portfolio, it focuses on five attributes, referred to collectively as CAMEL: capital adequacy, asset quality, management, earnings, and liquidity. At the discretion of the senior examiner responsible for the bank, the FDIC examination program may include a review of the bank's loan portfolio.

In addition to the supervisory program conducted by the FDIC, the State Banking Department conducts its own supervisory program. Using the same CAMEL system, the State Banking Department's examination scope alternates annually from a full scope examination to a targeted scope examination. A full scope examination covers all five CAMEL attributes. During a targeted scope examination conducted in alternate years, examiners focus on one or more of the five CAMEL factors; they visit the bank twice and conduct one analysis of reports in their office.

The Department Did Not Examine the MoneyCenter Frequently Enough To Detect Problems

Even if the department had more comprehensive examination procedures, the department did not examine the MoneyCenter frequently enough to detect the problems in its recordkeeping system and in its loan portfolio.

In August 1981, the MoneyCenter began operations under new management. Because this industrial loan company had been licensed since 1969, the department treated it as an existing company. It is the department's policy to conduct a quarterly examination 60 to 90 days after the change of management. Department examiners began their quarterly examination of the MoneyCenter's new management in February 1982, six months after it changed ownership.

Furthermore, the department's policy is to conduct a full regulatory examination once each year. However, the department did not conduct a full regulatory examination in 1982. In June 1982, the MoneyCenter moved its main office from Fullerton to Walnut Creek, and the department's regulatory authority for the MoneyCenter shifted from its Los Angeles office to its Sacramento office. Representatives from the department's Sacramento office visited the MoneyCenter in September 1982 to meet the company's management and to schedule a full regulatory examination for the Fall 1982. However, in September 1982, because of a change in policy, the department transferred jurisdiction for the MoneyCenter from its Sacramento office to its San Francisco office. The department's San Francisco examiners apparently were not notified that an examination was pending. Consequently, the department did not schedule the regulatory examination as it originally planned. Department examiners actually began their first full regulatory examination on June 20, 1983.

In contrast, the State Banking Department and the FDIC coordinate their examinations for banks in poor financial condition before and after they are taken over by new management. The FDIC examines a financial institution before it opens for business to evaluate and to document its financial soundness, its quality of management, and its compliance with the law. A major feature of this evaluation is to assign a supervisory rating to the institution. This rating determines the frequency and the scope of the FDIC's examination and monitoring of the institution. The FDIC policy is to examine an institution that has problems at least every 12 months. In addition, FDIC examiners must visit the institution each quarter in which there is no other supervisory activity occurring. If the institution changes ownership, the FDIC will visit it within 30 days of the change. The FDIC will then make quarterly visits until its first examination, which is required within the first year. The State Banking Department alternates its examinations with those of the FDIC so that the bank can be examined at least every 6 months.

Had the department treated the MoneyCenter as a new company when it changed management in August 1981, the department would have examined the MoneyCenter quarterly for at least two years to ensure that the company's management both understood the industrial loan laws and was operating in accordance with them.

The Department's Monitoring Procedures Are Poorly Defined and Are Not Carried Out

In addition to conducting field examinations, the department also monitors an industrial loan company's financial condition by analyzing periodic reports prepared by the industrial loan company management on forms the department provides. The department conducts a limited review to determine if the industrial loan company is complying with the lending limits, the thrift obligation limits, and reserves for estimated losses set by law. However, the department does not provide any written guidance to its examiners for analyzing the effects of changes from one period to the next. Further, the department does not compare an industrial loan company's performance with the performance of its peers to determine an industrial loan company's relative position within the industry. Finally, although the department says it reviewed the reports from the MoneyCenter for 11 months from August 1982 to June 1983, it failed to document the results of these reviews. Discrepancies in these monthly reports that should have triggered an inquiry went unnoticed. During that period, the MoneyCenter's thrift obligations increased from $22.4 million to $109 million, a growth of almost 400 percent for the 11-month period.

Our review of the MoneyCenter file showed that examiners, using a one-page checklist to assist them in their review, noted changes in a variety of accounts in the months for which they conducted reviews. However, the examiners drew few conclusions on the effect of these changes, and there was no evidence that questions raised by examiners were resolved.

In contrast to the department's examiners, the FDIC examiners use detailed manuals and instructions to assist them in their analysis of banking data. In addition, the examiners verify at their next field examination that a bank's reports agree with its records. At the State Banking Department, assistant deputies analyze each bank's operating data after the data are computerized and compared to the bank's previous record and to the records of its peer institutions. Assistant deputies note problems for immediate follow-up or for referral to the examiners.

In addition, there was no evidence that the department's examiners who were reviewing the MoneyCenter's reports determined whether the MoneyCenter was complying with the department's terms of approval for higher growth limits. For example, in May 1982, the department granted authority to increase the number of loans over $10,000 that the MoneyCenter could make and to increase the MoneyCenter's thrift ratio--the amount of thrift obligations it could accept compared to its capital and the unrestricted surplus it had accumulated. As a condition for the increase in the thrift ratio, the department required the MoneyCenter to establish special cash reserves and special reserves for losses. The MoneyCenter's reports do not indicate that these reserves were ever established or that the department's examiners reviewed the issue. In a progress report subsequent to its 1983 examination, the department found that the MoneyCenter failed to establish these required reserves.

Finally, during the 11-month period between August 1982 and June 1983 when the department failed to document its review of the MoneyCenter's reports, there were obvious inconsistences in the reports. For example, in the March 1983 report, the MoneyCenter reported an $800,000 increase in its capital account on the balance sheet. However, this amount did not appear in the cash flow summary, a supporting schedule. While this discrepancy is not conclusive (it could have been an error in reporting), it should have triggered an inquiry by the examiner. In fact, department examiners reported that the MoneyCenter had falsified seven of its reports from January 1983 to August 1983. For example, in its March 1983 report, the MoneyCenter falsified statements regarding when capital contributions were made. Finally, the examiners found that the MoneyCenter had dropped below the required amount of capital in March 1983 and in July 1983.

The department has taken steps to improve its system for monitoring industrial loan companies. It is currently in the process of computerizing its system for analyzing financial reports. This system will include comparative data from all industrial loan companies so that the department can evaluate an industrial loan company against its peers. The department is also developing an instruction manual for its examiners.

The Department Did Not Verify the Financial Data That Supported the MoneyCenter's Requests for Expanded Services and Higher Growth Limits

The MoneyCenter grew at a modest rate from August 1981, when it had $5 million in thrift obligations, to February 1982, when the department conducted its first quarterly examination and the MoneyCenter had $11 million in thrift obligations. In May 1982, the president of the MoneyCenter requested and received authority from the department for increases in the amount of thrift obligations it could accept and the amount of loans it could make in excess of $10,000. From March 1982 to June 1983 the MoneyCenter grew rapidly. Thrift obligations increased almost 700 percent to $109 million by June 1983.

The MoneyCenter supported its request for expansion with financial statements and supporting schedules. The department's former special administrator granted authority for expansion but stipulated conditions regarding reserves for loan losses and records that the MoneyCenter was required to maintain. The MoneyCenter also requested authority to expand into the leasing business. The department granted this authority on the condition that the MoneyCenter submit additional quarterly reports. During the period that the MoneyCenter was expanding its services, the special administrator also granted final approval for eight new branch offices. Although the MoneyCenter submitted numerous financial reports and projections that the department reviewed before it granted approvals, the department did not send its examiners to verify any of these data. Consequently, the

department did not determine if the actual financial condition of the MoneyCenter corresponded to the condition its president represented in his requests for expanded services and higher growth limits.

After its examination, begun in June 1983 and completed in October 1983, the department reported numerous deficiencies that prevented it from determining the actual financial condition of the MoneyCenter at any particular time. For example, financial records for the entire year's activity for the MoneyCenter's real estate loan portfolio needed to be reconciled to determine the validity of the portfolio. Examiners were hampered in their efforts to reconcile these records because the MoneyCenter incorrectly recorded its real estate transactions. According to a corporations examiner for the department, the department is currently developing summaries that will show the true rate of the MoneyCenter's loan delinquencies from July 1982 through the end of 1983 and the effect of these delinquent loans on the MoneyCenter's income and on the amount of its capital.

II

THE DEPARTMENT OF CORPORATIONS DID NOT USE THE AUTHORITY IT HAD TO DISAPPROVE THE WESTERN COMMUNITY MONEYCENTER'S REQUEST FOR ADDITIONAL BRANCH OFFICES

The department did not use the authority that it had to disapprove the MoneyCenter's request for additional branch offices. The department's examiners became aware of numerous material weaknesses in the MoneyCenter's internal controls during the course of their examination which began in late June 1983. Nevertheless, on August 22, 1983, two months after the department knew of the existing problems, a former special administrator for the department (now retired), gave his final approval of the MoneyCenter's requests for four new branches despite evidence that the company's financial condition as represented by its financial statements could not be relied upon. According to another special administrator, one of these branches actually opened. As a result, thriftholders associated with the new branch were needlessly placed at risk.

The department approves branch office applications in two stages. Before January 1, 1984, in the first stage, an industrial loan company had only to demonstrate that public convenience and advantage would be served by the new branch and that the industrial loan company had the capital required to open a new branch. Chapter 725, Statutes of 1983, added criteria for new branches. An individual loan company must now demonstrate that it has established operational controls for

its new branch and that the financial condition of the industrial loan company justifies establishing a new branch. After the commissioner approves the new branch based on the foregoing criteria, the industrial loan company organizes the new branch, hires staff, and prepares to open the branch. After completing these tasks and before opening the branch, the commissioner must give final approval to permit the new branch to open for business.

Regardless of the criteria added by statute on January 1, 1984, the commissioner had sufficient criteria under the law in effect in August 1983 to withhold final approval of the MoneyCenter's four new branches. The California Financial Code, Section 18147, states that the Commissioner of the Department of Corporations is not to approve an application for a branch office of an industrial loan company until he has ascertained to his satisfaction that the facts set forth in the application are true. In conjunction with the MoneyCenter's independent audit report for the year ended December 31, 1982, the auditors issued a management letter in May 1983 to the MoneyCenter's board of directors that listed a series of material weaknesses in the MoneyCenter's internal control procedures.*

*On December 22, 1983, the auditors withdrew their audit report for the year ended December 31, 1982, stating the report could not be relied upon. According to the auditors, the MoneyCenter had informed them of $2.4 million in loan losses that would appear to have affected the 1982 financial statements.

However, in their May 1983 management letter, the auditors noted that the MoneyCenter had not developed subsidiary ledgers for major accounts such as buildings and equipment, other receivables, intercompany transactions, repossessed real estate, and loan calculations. In addition to not categorizing the details of these transactions, the auditors found that the MoneyCenter had not reconciled these transactions to the general ledger control accounts. The auditors also found that the MoneyCenter had not reconciled some of its bank accounts to its bank statements. Reconciling the details of daily business transactions to control accounts is a critical step in assuring that all of the daily transactions are summarized and are reflected in an entity's financial statements.

Department examiners corroborated the deficiencies noted in the auditors' reports in an internal memo to a senior examiner on July 26, 1983, nearly one month before the department gave final approval for the last four branches. In addition, department examiners noted that the MoneyCenter had not established the reserves required for potential losses in its loan portfolio. The additional reserves for losses were a condition of the department's approval in May 1982 for an increase in the MoneyCenter's outstanding thrift obligations. According to the examiner's calculations, the additional $1.4 million in required reserves would exceed the MoneyCenter's earnings to date as well as earnings from earlier periods.

One of the objectives of internal accounting controls is to provide management with reasonable assurance that financial records are reliable enough to permit the preparation of financial statements. Since the auditors and examiners had reported material weaknesses in accounting controls at the MoneyCenter, there was no assurance that the actual substance of the MoneyCenter's business transactions was recorded or that these transactions were accurately translated into the financial statements. There was also no assurance that the financial data the MoneyCenter presented in its application for four new branches were reasonably accurate. Nevertheless, a former special administrator for the department granted final approval for these branches on August 22, 1983, two months after the department first became aware of the extent of the accounting problems at the MoneyCenter. This former special administrator told us that he approved the branch offices based on assurances from the MoneyCenter's management that its financial problems would be corrected. However, the MoneyCenter's financial problems were not corrected. Consequently, the thriftholders associated with the one office that opened were needlessly placed at risk.

Changes in the Regulation of Industrial
Loan Companies Insured by the FDIC

The FDIC has adequate methods of supervising the institutions it insures. Its program is "risk-oriented"; that is, it focuses on the operations of banks, including troubled banks, in which exposure to risk is greatest. The FDIC has also initiated other actions to reduce

the amount of risk a bank can take. It has raised the amount of capital a bank needs, and it has taken formal enforcement actions against problem banks and their officers and directors. The FDIC can also assess monetary penalties and initiate termination-of-insurance proceedings against any bank in an unsafe or unsound financial condition.

The FDIC and the department are planning to implement a joint examination program for the State's industrial loan companies insured by the FDIC. As of October 1985, the program was still in the planning stages. While the level of supervision has increased for industrial loan companies insured by the FDIC, more needs to be done to ensure that those industrial loan companies regulated by the department and guaranteed by the Thrift Guaranty Corporation are subject to the same level of supervision.

III

CONCLUSION AND RECOMMENDATIONS

The Department of Corporations does not have the methods of detecting the types of conditions that led to the failure of the MoneyCenter. The department does not conduct examinations that address the quality of a company's assets. However, the department has recognized its deficiencies and is developing an examination program to increase its supervision over the industrial loan companies it regulates. Also, Chapter 1349, Statutes of 1985, which allows industrial loan companies to convert to FDIC insurance and FDIC regulation, will help to ensure that these deficiencies in supervision do not reoccur.

The department's monitoring procedures are poorly defined. In addition, the department failed to document its review of the MoneyCenter's financial reports during an 11-month period of extremely high growth. The department now has computerized the monitoring system to compile the statistical data and to provide a comparison of these data among industrial loan companies. The department is also preparing a manual for use by its examiners to assist in analyzing the effects of changes they observe in industrial loan company reports.

In addition to deficiencies in the department's supervisory program, the department also did not verify any of the financial

statements or projections the MoneyCenter presented in support of its requests for additional services, increased growth limits, and new branches.

Finally, the department failed to exercise the authority it had to disapprove the MoneyCenter's request for additional branch offices. Even after the department knew that the MoneyCenter's financial records could not be relied upon, the department's former special administrator gave his final approval for four new branches on August 22, 1983, eight months before the department took over the MoneyCenter. One of these branches actually opened, needlessly placing the thriftholders associated with that office at risk for the loss of their funds. Ultimately, the State's taxpayers are at risk to the extent that the MoneyCenter's assets are insufficient to repay the $63 million loan the State guaranteed to pay off the MoneyCenter's thriftholders.

RECOMMENDATIONS

To provide the same level of supervision that the FDIC-insured industrial loan companies have, the department should develop a comprehensive examination and monitoring program for the industrial loan companies that have not or will not obtain FDIC insurance for their thriftholders' accounts. In the course of developing the joint examination program with the FDIC, the department should apply the same principles and procedures to the remaining non-FDIC insured industrial

loan companies. Furthermore, in developing its instruction manual for its examiners, the department should include instructions that require examiners to document their reviews of periodic reports sent to the department by industrial loan companies.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Kurt R Sjoberg
for THOMAS W. HAYES
Auditor General

Date: February 18, 1986

Staff: Thomas A. Britting, Audit Manager
Eileen Worthley, CPA
Mark Lamb, CPA
Thomas Sachs

CHRONOLOGY OF EVENTS AT THE WESTERN COMMUNITY MONEYCENTER

August 25, 1981	The Community Financial Group purchased the Charter Thrift and Loan (Charter), which held $5 million in thriftholders' accounts and had one office.
September 1981	The Department of Corporations' (department) examiners began monthly analyses of financial reports prepared by Charter's new management.
March 19, 1982	The department reported on its initial examination of Charter's recordkeeping system. No material exceptions were noted.
June 1982	The department approved two branch locations for Charter. Charter changed its name to the Western Community MoneyCenter (MoneyCenter) and moved its main office from Fullerton to Walnut Creek. The department's regulatory responsibility for the MoneyCenter shifted from its Los Angeles office to its Sacramento office.
September 1982	Due to a change in policy, the department transferred jurisdiction for regulatory responsibility from its Sacramento office to its San Francisco office.
April 1983	The department received the MoneyCenter's independent audit report prepared by its CPAs for the year ended December 31, 1982. No material exceptions were noted. The department sent Thrift Guaranty Corporation a copy of the audit.
May 1983	The Thrift Guaranty Corporation informed the department of its concern over the MoneyCenter's rapid growth. The president of Thrift Guaranty met with representatives from the MoneyCenter and the department to discuss their concerns. The MoneyCenter's CPAs issued a management letter in conjunction with their audit for the year ended December 31, 1982. The CPAs noted numerous material weaknesses in the MoneyCenter's accounting internal controls.

June 1983	The department commenced its first full regulatory examination of the MoneyCenter's operations on June 20. Department examiners withdrew after two days because the MoneyCenter's records were not auditable. On June 23, the department ordered the MoneyCenter to stop taking new thrift obligations because the company lacked adequate accounting records. The MoneyCenter protested this action, stating that it would cause a run on the company and the company would be unable to control the outflow of funds. Approximately 30 percent of its thrift obligations was in demand deposits accessible through automated teller machines or N.O.W. accounts (checking accounts). The department rescinded the order; the MoneyCenter agreed to bring its records current by July 1.
July 26, 1983	Department examiners confirmed findings reported in the independent auditor's management letter prepared in conjunction with the December 31, 1982, audit. The MoneyCenter had material deficiencies in its internal accounting controls. In addition, there were insufficient reserves for losses in its loan accounts and understated loan delinquencies.
August 2, 1983	The department met with MoneyCenter officials to discuss the company's lack of accounting records, unreported loan delinquencies, and related deficiencies in reserves for loss accounts, and prohibited intercompany transactions. The MoneyCenter agreed to reduce its outstanding thrift obligations from $125 million to $120 million by August 31.
August 24, 1983	The department's special administrator granted final approval for four new branches.
September 16, October 4, October 24, 1983	A department examiner issued internal progress reports summarizing the extent of the MoneyCenter's statutory violations.
November 2, 1983, November 22, 1983	The department issued administrative orders to the MoneyCenter to cease and desist from numerous statutory violations including deficiencies in net worth, falsifying reports, failing to maintain appropriate accounting records, making improper loans, and engaging in prohibited intercompany transactions. The department also ordered the MoneyCenter to discontinue making loans or selling off its assets.

December 6, 1983	The department reported the results of its November 17 meeting with the MoneyCenter's management to the MoneyCenter's attorney. The department noted that a sale of the MoneyCenter and/or complete replacement of the company's management with an infusion of new capital would be acceptable. The department expected a proposal from the MoneyCenter by January 17, 1984, with implementation no later than February 17, 1984.
December 22, 1983	The MoneyCenter's independent auditors withdrew their audit opinion issued on the results of the MoneyCenter's operations for 1982. The MoneyCenter's management had informed the auditors of $2.4 million in loans that the MoneyCenter had to repurchase, affecting its 1982 operations. The auditors, therefore, stated that their opinion could no longer be relied upon.
February 24, 1984	The department issued orders to the MoneyCenter to increase its capital to the level required by the law. The law provides 60 days to the company to comply with this order.
April 20, 1984	The department took possession of the MoneyCenter because it failed to increase its capital.

STATE OF CALIFORNIA—BUSINESS AND TRANSPORTATION AGENCY GEORGE DEUKMEJIAN, *Governor*

DEPARTMENT OF CORPORATIONS
OFFICE OF THE COMMISSIONER
600 S. COMMONWEALTH AVENUE
LOS ANGELES, CALIFORNIA 90005
(213) 736-2741

IN REPLY REFER TO:

FILE NO. ________ ________

February 20, 1986

Mr. Thomas W. Hayes
Auditor General
State of California
660 "J" Street, Suite 300
Sacramento, California 95814

Dear Mr. Hayes:

Subject: Report P-525

Secretary John Geoghegan of the Business, Transportation and Housing Agency has requested that I write directly to you to respond to your invitation to him to comment upon the referenced report. It is our understanding that this letter will be included in the report.

As you know, complex civil litigation seeking to assess reponisibility for the failure of Western Community MoneyCenter has been filed by the State of California. Those actions ask substantial monetary recovery from those responsible. In addition, claims pursuant to Government Code Section 810, et seq. and related litigation have been filed against the State of California and certain individual state employees in connection with Western Community MoneyCenter. Many millions of dollars in potential damages are sought through those claims and associated litigation. During the course of the claims process and in the litigation, all of the facts will be developed through the process of discovery and investigation preparatory to trial. Thus, numerous statements and conclusions contained in this report are premature, and any detailed response by the Department is likewise premature.

Originally, your staff advised the Department that the report is intended to be a neutral statement of facts. Despite this statement, and with full knowledge of the pendency of the litigation, which is only in its initial stages, our review of the draft of the report has led us to conclude that the report is incomplete, based on insufficient facts, speculates about hypothetical actions of other regulatory agencies and draws inaccurate and misleading inferences and conclusions from facts which have been only partially developed. Nevertheless it is our understanding that you intend to issue the report despite its numerous defects and despite the inappropriate timing of such issuance. As you are aware, these concerns have been fully discussed in several meetings with your staff.

In light of the pending litigation, it is not appropriate for the Department to set forth its position concerning matters that are now before the courts without having the benefit of the discovery process that is specifically intended to develop the facts necessary to arrive at that position. Indeed, the report and your request to respond to it places the State of California at a needless disadvantage. On the one hand, the State's opponents in the many lawsuits will await the development of the facts through the discovery process. On the other hand, the report and your request to respond to it require the State to decide now whether to set forth its legal and factual position without having the benefit of the information, investigation and research that will later become available. In discussions preceding the finalization of this report, the Department made this position clear to your office.

The outcome of this litigation and these claims will materially impact the creditors, certain account holders and other claimants against Western Community MoneyCenter and may make the difference between whether these claimants eventually recover the full amount of their claims or suffer substantial loss. Moreover, the taxpayers of the State of California have committed, through legislation enacted last year, $63,000,000 from the State's general fund to guarantee a private loan which enabled the account holders to secure the return of their account balances up to $50,000. Finally, the taxpayers are at risk with respect to millions of dollars of claims made against the State of California by those who are attempting to shift the responsibility for Western Community's failure from its former management to the State. Whether this risk to the taxpayers ultimately results in a loss will be determined in large part by the success of our efforts to recover against the former management of Western Community MoneyCenter and others who were responsible for the failure of this institution. We intend to press forward with our efforts to secure recovery for the estate and to vigorously defend the State and its taxpayers.

In the interests of intragovernmental cooperation, the Department in meetings with your staff, pointed out factual errors in the report. In addition, the Department identified areas where the report was incomplete, based on insufficiently developed facts and areas where the report drew inaccurate or misleading inferences. The Department advised your staff that these errors and areas identified were intended to be illustrative only and were not to be construed as a complete statement or list of errors and objections, or by way of inference or omission, a validation of any portion of the report.

In sum, the Department believes the report is premature and objects to any opinion, conclusion, implication or inference in the report which states, implies, or infers that the Department has violated any law, regulation, policy or practice. Due to the pendency of claims and litigation, any further comment on the contents of the report is, on advice of counsel, not now appropriate and cannot be made.

Yours very truly,

Franklin Tom by RM

FRANKLIN TOM
Commissioner of Corporations

FT:bf

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*Auditor General's rebuttal to the department's comments.

After our meetings with the department, staff from our office spent a full week following up on each factual error that the department contended existed in our draft report. As a result of this work, we made minor technical word changes and minor editorial changes in those areas of the report that required such changes. However, in no instance did any of the additional facts provided to us by the department change any of the conclusions in the report.

Our report is fully supported by evidence that we have in our files, and the evidence clearly supports the statements of fact and the conclusions we reached.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps